pensions, endowments and foundations find

Whether due to market downturns, historically low interest rates, or increasing pressure to meet financial obligations, more and more pension funds, endowments and foundations are viewing securities lending as a viable means to gaining a competitive edge and delivering on their promises.

For many of us, the very mention of pension funds, endowments and foundations calls to mind those prudently run institutions, dedicated to safeguarding their members' contributions and investing them wisely so as to build and preserve a sizable stable of assets. In times past, however, "prudence" sometimes precluded considering opportunities to achieve profits or revenue beyond the conventional.

Within the last decade, that has changed. Spurred in part by the bear market of 2000–2002, low interest rates, heightened market volatility and overall competitive pressure to generate favorable returns, lending assets — as well as borrowing to boost them — has become an integral part of many a prudently run pension fund, endowment or foundation.

The reason is simple. "The primary driver to lend for these entities is virtually the same as for any asset manager — the ability to earn incremental income," says Bob Betz, manager New Business Development, JPMorgan Investor Services Securities Lending.

"We can provide a wide range of choices through our ability to construct

Certainly, while the recent lags in investment performance and funding requirements from both U.S. stocks and bonds in recent years have provided a natural impetus for pension funds to incorporate lending into their overall asset management activities, the evolution in the securities lending industry itself has provided incentive too. One example of such an incentive is the overall flexibility in terms of program management that firms such as JPMorgan offer.

"Lending has undergone a subtle but significant turnaround in the past decade or so, in terms of how pension funds perceive it as a source of revenue," says Tom Christofferson, business executive for the Institutional Investors Group, JPMorgan Investor Services Global and North American Client Management.

Specifically, Christofferson says that many current JPMorgan pension clients as well as other U.S. pension funds are attracted to JPMorgan's lending program due to its ability to customize lending agreements and program guidelines to meet each client's risk preferences. "This increased interest in securities lending is due, in large part, to the flexibility we are able to provide in terms of dealing with clients' specific risk parameters around collateral reinvestment. Now, more than ever before, clients can set their own tolerance, or establish a program around the risk/reward trade-off that they're seeking to obtain," Christofferson adds.

Overall, the program's increased options seem to offer the right mix for the pension, endowment and foundation market segment. "Whether in terms of collateral reinvestment guidelines, or in putting the various and diverse assets pension clients have in their portfolios to work via the strategies we offer, or through the potentially different kinds of collateral we can consider, we provide a wide range of choices through our ability to construct dedicated lending arrangements," he says.

growing appeal in securities lending

Competitive Edge at Hand

According to some pension fund managers, lending activity is no longer regarded as a peripheral activity, but rather is viewed as a reliable and valuable source of incremental income.

"We've been using JPMorgan's Securities Lending program since we became a custody client in 1995," says Kathy Reissman, CFA and director of investments for Texas Employees Retirement System. "At the time we had some stringent statutes in place that not only required us to be indemnified against borrower default, but also against reinvestment risk. Most securities lending operations weren't willing to provide that, but JPMorgan did. Further, once we were successful in getting those statutes changed, it really freed up the Securities Lending team to do more with our securities."

For many fund managers, the incremental income potential is serious business. For a fund manager competing within a tightly risk-controlled band versus a given benchmark, an additional 15 basis points of return could mean the difference between trailing and outperforming most of one's peers within a similar allocation. While some pension funds do not permit their investment managers to include lending income in performance measurement, others do, making the option all the more attractive.

"One of the things I like most about the program JPMorgan has put in place for our funds is that it's fairly conservative," Reissman explains. "We aren't looking to be exposed to a great deal of risk. Where we don't expect to see extremely

dedicated lending arrangements."

high returns, our securities lending activity generates a meaningful amount of dollars relative to our operating budget, which is very helpful," she continues. "Our experience has been very positive; they've delivered what they promised."

Scale Appeals to Smaller Funds

Another reason for pension funds' heightened interest in lending over the past decade is that the securities lending industry has widened its overall offerings to permit smaller pension funds — not traditionally a typical lending client — into the fold.

"In the past, securities lending was typically associated with larger plans," says Gene Picone, global head of Securities Lending, JPMorgan Investor Services. However, Picone explains that JPMorgan took active steps to offer smaller plans an opportunity to profit. "We have long held the view that customized collateral accounts present the best option for clients when it comes to maximizing revenue," he concedes. "However, with thin spreads currently in the marketplace and with interest rates continuing to remain historically low, we have revisited our own strategy, realizing that there are times when clients — who perhaps have smaller pools of cash — may not necessarily benefit from a pure distribution strategy."

One component making JPMorgan's Securities Lending program more attractive to smaller pension funds is the creation of a commingled investment fund in 2003, specifically designed to serve ERISA plans with smaller asset pools. The fund today holds $1.8 billion in collateral, and offers a yield 17 basis points over the target rate, typically benchmarked against the U.S. Federal Funds Rate. JPMorgan followed this in May 2004 with a second commingled vehicle, aimed at serving other types of institutional investors including non-ERISA endowments, foundations and mutual funds who have less than $300 million in cash collateral.

"Typically, clients with smaller plans generate smaller cash collateral balances. In order to assure proper cash collateral liquidity, investments are made on a very short basis with a short weighted average maturity; the smallest portfolios are solely invested in overnight maturities," explains Gene Gemelli, manager Western Hemisphere Relationship Management, JPMorgan Investor Services Securities Lending. "As a result, the yield generated on that cash is low, and with a low yield a lender may be precluded from making loans of securities that demand relatively high rebates." This is due to the spread between the investment and the rebate being simply too small or zero.

"When we commingle that cash into much larger pools, however, the yield issue is addressed, and JPMorgan is free to use a longer, yet still prudent, weighted average maturity on the pooled investments," he adds. As a result, prospective clients, that may have previously feared their portfolios were too small to participate in lending, can now generate significant earnings.

First Things First: Understanding the Risks

While macro conditions were ripe for pension, endowment and foundation clients to consider lending, they first had to gain understanding and comfort about lending *per se*. "It was time for this client base to confront the facts about the potential risks and rewards of lending activity, and realize how lending could potentially mean the difference between trailing your peers and outperforming them," says Gemelli.

"Essentially there are three core risks inherent in lending," he says. "The first is operational and settlement risk, or the potential for processing mistakes and errors. This is generally the least of clients' concerns, since security industry settlement infrastructure, combined with refined procedural and system processes, have greatly reduced this risk. The second is counterparty risk, or the risk of an insolvent borrower failing to return borrowed securities (including non-cash distributions)." This risk is significantly mitigated by daily marking-to-market to maintain full collateralization, as well as by JPMorgan's extensive indemnification, according to Gemelli.

"JPMorgan's indemnification against borrower default provides generally that, if the value of the collateral posted by the borrower is insufficient to replace the securities (or non-cash distributions) that have not been returned, the Bank will gross up the difference between the replacement cost and the value of the applicable collateral (net of any cash collateral investment losses)," he says. Indeed, one of the many positive developments emerging from the JPMorgan/Bank One merger is that JPMorgan's capital base will grow from $42 to $69 billion. "This capital backs our indemnification," says Gemelli.

The third risk inherent in securities lending is associated with incurring a loss on cash collateral investments. A loss could result from an investment default, a lender's instruction to liquidate an investment prior to maturity at a time of rising interest rates, a sudden need to return cash collateral (thereby creating a liquidity issue) or rebates spiking above the cash collateral yield (potentially resulting from a large loan/investment mismatch). "Again, we have policy, systemic and client customized safeguards in place to manage this category of risk," says Gemelli. The protections range from real-time compliance with each client's specific investment guidelines, independent post-trade compliance and overlaid JPMorgan Market Risk Management Policies, such as assuring that at least some investments mature every day.

securities lending: what you should know

Understanding the basics of lending should include reviewing not only the processes involved, but most important, the risks inherent in any lending transaction, says Bob Betz, manager of New Business Development, JPMorgan Investor Services Securities Lending. "Our process with a prospective client begins with education. We don't start by discussing numbers; we first explore their views of lending, and what their expectations are. Most crucial, however, is an in-depth understanding of the risks," he stresses.

Betz explains that while the process of examining risk sources, methods of risk management and indemnification can require time and careful consideration, "It's fully worth it," he says. "When our exploratory process is complete, a potential client can then review bids and respond with specific questions as to how each bidder came up with its numbers. This enables a client to understand the differences among the programs offered by various lending agents." Before an institutional investor becomes a JPMorgan lending client, he adds, "We aim to help them convert the proposed economic result of any bid into an understanding as to whether or not the risks outweigh the potential incremental return that one bidder proposes over another."

The Basics of Lending

Securities lending takes place when an investor lends securities from their portfolio to a borrower that needs those securities for various business purposes. In the case of pension funds, the borrower is typically a major broker-dealer that needs the securities — often on short notice — to cover a short position in its role as a market maker.

Not to be ignored is the depth of JPMorgan's short-term fixed income research capability, a key element in reducing the likelihood of a lender holding a defaulted investment. "We have a unique advantage among all our peers in that our investment management subsidiary — JPMorgan Fleming Asset Management — provides us with a depth and breadth of research which itself is supported by a number of different businesses," explains Jim Wilson, Investment Management executive, JPMorgan Investor Services Securities Lending. "We're leveraging our formidable infrastructure and the size of our institution to create, maintain and exploit this shared utility, that provides us with research far superior to that which we could obtain as a stand-alone business."

More Good News on the Horizon

The securities lending activities of plans subject to ERISA are poised to get a boost and have available even more profit opportunities, if regulations proposed by the Department of Labor ("DOL") become effective. The DOL's proposal would, for the first time, allow ERISA-governed pension plans to lend securities to U.K.-based borrowers and to take collateral for those loans denominated in either pounds sterling or euros. Currently, plans can lend only to U.S.-based borrowers and take collateral denominated in U.S. dollars.

According to Picone, who, along with other prominent industry executives in tandem with the Risk Management Association (RMA) , has been working for over 10 years to get the rules changed, the greatest benefit will be from increased opportunities to lend international securities. "The new rules are coming in at just the right time," says Picone. "Foreign collateral has found a strong niche in the securities lending arena," he explains. Additionally, the new rules will likely lead to increased revenue for plans since "plans will either make more loans or receive a better fee for the same amount of loans," he adds.

Betz agrees, saying, "This change will give plans a greater opportunity to earn," since non-U.S. equities, for example, offer a higher revenue opportunity from a lending perspective than, say, domestic stocks. Some segments of the pension, endowment and foundation markets stand to benefit even more, particularly the public sector. "Many public pension plans, which for years have looked to ERISA and the DOL as their defacto regulators when it comes to lending, have portfolio structures that tend to favor higher concentrations in non-U.S. equities."

Indeed, if and when the new rule goes into effect, it is expected to have a substantial influence over the lending of international securities and fixed-income lending. According to Wilson, "We have many clients who participate in non-U.S. markets that are currently locked down to only having a reinvestment option in the States," he says. "This will open many new doors, offering the ability to manage across more asset classes, and thereby making this proposition very attractive to lenders."

Overall, the increased acceptance of lending among pension funds and the like continues to be driven by a favorable climate for lending, as new options become available and as programs such as JPMorgan's continue to meet the changing needs of this unique client base. Says Picone, "When a portfolio must sustain itself, as pension, endowment and foundation assets are required to do, and as competitive pressure from peers mounts, fund managers need to find reliable sources of income over time. It's no surprise that in recent years, pension executives have asked themselves, 'What are prudent managers doing in similar circumstances?'" The answer, Picone says, "They're lending." ○○○

The borrower provides collateral for the loan, typically equivalent to 102% of the value of the securities borrowed where the securities borrowed and the collateral are in the same currency and 105% where the securities borrowed and the collateral are in different currencies. The initial collateral is then marked-to-market throughout the term of the loan to assure, among other things, that no loan has less than 100% collateralization. This generally means that, during the term of the loan, further collateral must be provided by the borrower if the value of the lent shares rises (or the value of securities collateral falls), while collateral must be returned to the borrower if the lent shares fall in value (or the value of securities collateral rises).

The lending agent invests the collateral, when in the form of cash, in relatively short-term securities that earn interest. A negotiated portion of this income is rebated back to the borrower, with the remainder shared between the lender and the lender's agent, according to the term of the agreement between them. Where securities or letters of credit are posted as collateral, the borrower pays an agreed borrowing fee, which again is shared between the lender and the lender's agent in an agreed proportion. At the end of the loan, the lent securities are returned to the lender (and collateral is either returned to the borrower or allocated to other loans needing collateral).

Typically, where a prospective lender's custodian bank, such as JPMorgan, has substantial lending expertise, the custodian is appointed as the lending agent.